*Promoting Retail Investor Participation in Government Bonds**

Harun R Khan

I am extremely happy to be invited for this important conference on capital markets organised by the ASSOCHAM, I am particularly pleased as the focus of the conference is on Investors who alongwith Issuers, Instruments, Intermediaries, (market) Infrastructure, Incentives & Innovation constitute, what I call, the 7' I critical pillars of a robust and resilient debt market. Given the low level of participation of retail investors in equity and more so in debt markets, the specific theme of the conference aimed at the retail investors is most appropriate. Retail participation in financial instruments has assumed critical importance as the overall savings rate, which has been one of the strong points of our economy, has declined from the high of about 37 per cent to about 32 per cent of the GDP and the share of household financial savings as percentage of GDP has also declined from about 12 per cent to eight per cent last year.

2. As the conference schedule indicates that different aspects relating to upscaling of retail participation in the financial markets have been discussed, I have chosen to share my thoughts primarily on one very important segment of the financial market – that of Government securities (G-sec) where retail participation has been unsatisfactorily non-existent. I would briefly look upon the importance of the G-sec market and the need for participation of the retail investor in this market, motivations for such investors for choosing G-sec, measures taken by the Reserve Bank of India to encourage participation of retail/mid-segment investors, constraints on their participation in this market and some thoughts on measures that could be taken to fast-track the retail/mid-segment participation in G-sec market.

3. Over the past two decades since we began the financial sector reforms, Indian government bond markets have come a long way. The annual gross market borrowing of the Government of India and the State Governments increased from ₹122.83 billion in 1991-92 to ₹6686.32 billion in 2011-12. The amount of outstanding Government of India securities increased from ₹780.23 billion in 1991-92 to ₹27,881.56 billion in 2011-12. The monthly volume in secondary market on the electronic trading platform – Negotiated Dealing System-Order Matching (NDS-OM), which accounts for about 90 per cent of the trading, has increased from ₹314.30 billion in August 2005 to ₹2650.17 billion in November 2012. Over the years the G-sec market has become broad-based, with yield curve spanning upto 30 years. The infrastructure for trading, clearing and settlement in the form of trading platform of NDS-OM with the Clearing Corporation of India Limited (CCIL) acting as the Central Counter Party (CCP) can be considered as world class, making it one of the safest financial markets to transact. The fact, however, remains that the market is predominantly institutional.

Need for retail investors

4. The traditional investor base for G-sec in India comprised banks, provident funds, and insurance companies. With the entry of co-operative banks, regional rural banks, pension funds, mutual funds

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and non-banking finance companies, the institutional investor base has been reasonably diversified. There is, however, very little retail participation in the G-sec market.

5. Catering to the needs of retail investors is often an essential part of the overall strategy to develop a more diversified investor base for government securities. Reliance by governments on captive sources of funding whereby financial institutions are required to purchase and hold government securities is diminishing in many countries. Instead countries are developing a diversified investor base for their G-sec. In Indian context, the Statutory Liquidity Ratio (SLR) prescription in terms of which banks are required to hold certain percentage of net demand and time liabilities (NDTL) has also been declining.

6. Retail investors will contribute to a stable demand for G-sec, which, in times of volatility, can cushion the impact of sales from institutional and foreign investors. Retail demand has been developed in many countries through special non-tradable instruments although this strategy will not contribute to development of the G-sec market. In India, retail investors invest in small saving instruments issued by government some of which (*e.g.*, National Saving Certificate VIII issue) entail tax benefits enhancing their attractiveness. These instruments, however, do not have a secondary market thereby limiting liquidity and have no possibility of capital appreciation.

7. Promoting retail and mid-segment participation in G-sec market is beneficial to both the issuer and the investor. From the issuer's perspective, a diversified investor base for government bonds is important for ensuring stable demand in the market. A heterogeneous investor base with different time horizons, risk preferences, and trading motives ensures active trading, creating liquidity and allows borrowings at reasonable cost. From the investors' perspective, there is a need for investment options that provide decent returns and protect the capital. G-sec are apt investment products that would cater to these needs. In spite of such features, there is low retail interest in the government bonds and this investor apathy needs to be tackled by the regulators and market bodies.

Advantages for retail investors

8. For the retail investor, G-sec offer one of the better options for investment. The advantages for retail investors can be listed as under:

a. *G-sec are risk free*

G-sec in domestic market context are risk free and carry no credit risk. Though this assertion is being widely debated in wake of the events unfolding in the Eurozone sovereign debt crisis, the fact remains that G-sec in the Indian context are risk free.

b. *G-sec offer decent yields for longer duration*

Currently, G-sec offer yields ranging from 8.00 per cent to 8.30 per cent and the tenor of securities extend up to thirty years. With government issuing securities at different points on the yield curve, G-sec offer an attractive option for savers who need low risk investment options for longer durations.

c. *G-sec offer prospect of capital gains*

As there is an inverse relationship between bond price and interest rate, there is a prospect of capital gains when the interest rates moderate. One, however, must be conscious of market risks that could result in losses in case the interest rate cycle reverses.

d. *G-sec have reasonable liquidity*

G-sec have reasonable liquidity and can be transacted on NDS-OM. Retail investors can trade easily through banks and primary dealers with an SGL account in RBI.

e. *G-sec help to diversify portfolio*

Investments in government securities would help in portfolio diversification and consequently reduce risk for retail investors.

Drivers of retail participation

9. The low retail interest in government securities stems from reasons, such as, low awareness and understanding regarding the market; availability of competing financial instruments of broadly similar characteristics; high transactions costs for intermediaries and lack of convenient access to the market. For market development, it is necessary to develop efficient mechanism for delivering simple products to retail clients. In many emerging markets, the administrative and information technology costs of going straight to retail investors have been prohibitive. With advent of internet and wireless communication systems gaining wide acceptability, this situation is, however, rapidly changing, and possibilities for cost-efficient sale and distribution of government securities are increasing. Leveraging such new technology to access a broader set of potential investors could also have implications for the design and functioning of the market and could change investor profiles.

10. In order to promote retail participation, it is essential to promote financial literacy and investor education, ease access to the G-sec market by leveraging technology and incentivising intermediaries including use of obligation in primary dealers/banks, *etc.* to place securities with end investors; incentivising Collective investment vehicles, such as, mutual funds, to cater to investment needs of the retail investors in G-sec market.

11. They can also serve as an alternative placement for funds other than bank deposits, inducing more competition in this part of the financial sector, and can be a cost-effective way for the government to reach retail investors.

Measures taken by the Reserve Bank of India

12. Notwithstanding the predominantly institutional character of the G-sec market, Reserve Bank of India has recognised merit in promoting retail participation and has initiated several policy measures to this end (Box 1).

Box 1: Initiatives taken by Government and the Reserve Bank of India to develop retailing of G-sec

The Government Securities Act, 2006: The Act has several features, such as, allowing pledging the Government securities for availing loans, legal recognition of ownership to holdings in gilt accounts, introduction of nomination facility, *etc.* to facilitate retail investors holding G-sec.

Non-competitive bidding in primary auctions: Non-competitive bidding facility has been allowed in the auction of dated Central Government securities. This facility is open to any person including firms, companies, corporate bodies, institutions, provident funds and trusts not maintaining a current account or an SGL account with the Reserve Bank.

Introduction of odd lot: A separate odd-lot segment has been created for the purpose of retail participation wherein the minimum market lot size has been kept at ₹10,000 for G-sec and ₹25,000 for T-bills. Odd lot segment has trades below ₹50 million.

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Improvement in settlement mechanism: A new settlement mechanism (Multi Modal Settlement) through commercial banks has been put in place for entities not maintaining a current account with the Reserve Bank and not regulated by Reserve Bank.

Retail debt segment on stock exchange: Reserve Bank has permitted trading of G-sec on stock exchanges in 2003. NSE had launched a retail debt segment to encourage wider participation of all classes of investors across the country (including retail investors) in G-sec. In order to attract retail investors, minimum lot size has been kept low at ₹1,000 (face value).

Investor education: With a view to bringing about awareness among the smaller players, such as, co-operative banks, provident funds, trusts, *etc.*, the Reserve Bank has been organising workshops in major towns. Reserve Bank has also prepared a primer on G-sec market which is available on the Reserve Bank website (http://www.rbi.org.in/commonman/English/scripts/FAQs.aspx?SID=7).

Web based access to Gilt account holders: Reserve Bank has introduced a web-based facility wherein gilt account holders can participate in primary and secondary G-sec market using internet.

Incentives to financial institutions and intermediaries: PDs have been allowed to take into account non-competitive bids for fulfilment of bidding commitment and prescribed success ratio. Similarly, banks have been allowed for undertaking retailing in G-sec with non-bank clients on outright basis and there is no restriction on the period between sale and purchase. A scheme of liquidity support to the gilt funds has been put in place, under which Reserve Bank provides collateralised liquidity support up to 20 per cent of holdings in G-sec for a maximum period of 14 days.

Widening NDS-OM membership: With a view to widening the secondary market in G-sec to mid-segment investors, well-managed and financially sound Urban Cooperative Banks (UCBs) have been permitted to become direct members of NDS-OM.

Retailing by PDs: In order to bring more retail and mid segment investors in Government securities market, under new authorisation policy for PDs (2011), Reserve Bank of India has mandated primary dealers to achieve an annual turnover target on behalf of mid-segment and retail investors that should not be less than 75 per cent of minimum NOF.

DVP-III facility to gilt account holders: To enable the gilt account holders to get the benefit of efficient use of funds and securities, Reserve Bank has extended the DvP – III facility to all transactions undertaken by the Gilt Account Holders except transactions undertaken between Gilt Account Holders of the same custodian.

13. To ease the process of investment by retail/mid-segment investors, a web-enabled platform which would seamlessly integrate their funds and securities accounts has been planned by the Reserve Bank of India. Some major banks have also initiated measures like on-line trading portal for the retail investors. Recently, the Reserve Bank has introduced a web-based solution for direct participation of all gilt account holders in the primary auction for G-sec as well as the secondary market transactions (Box 2).

14. Considering wide reach of exchanges, approach of allowing retail investors to access the G-sec market through stock exchanges can be one of the most feasible options. The Reserve Bank had also allowed buying and selling of government securities through stock exchanges since 2003 to facilitate easier access and wider participation. Trading volumes, however, continue to be very low in the exchanges. The Working Group on Enhancing Liquidity in the Government Securities and Interest Rate Derivatives Markets

Box 2: Web-based access to retail and mid-segment investors in G-sec

In order to facilitate direct participation of retail and mid-segment investors in the secondary market for G-sec, a web-based secondary market module was launched in NDS-OM in June 2012. The web-based system is in addition to the existing voice market. Before the launch of this facility, various non-NDS members {Gilt Account Holders (GAH)} were placing their bids through Primary Member (PM), *i.e.,* the NDS Member with whom GAHs have gilt account and current account. In the web-based system, PMs continue to be responsible for settlement of both the fund and security leg of the G-sec transactions of GAHs. In the web-based system, the GAHs are in a better position to control their orders and have access to real time live quotes in the market which enhances transparency. Further, they are better placed to manage their position since notifications of orders executed as well as various queries are available online. The GAHs have shown a reasonable interest in web-based secondary market platform.

To further enhance the access of GAHs to Primary Auction system, the Reserve Bank has also introduced an internet based solution wherein GAHs were given direct access for participating in primary auctions. With the introduction of this facility, GAHs have better control over their bids and can participate more effectively in the primary auction process. PMs continue to be responsible for the settlement of such bids placed by their GAH as earlier.

As the Core Banking Solution (E-Kuber system) of the Reserve Bank of India replaced Primary Auction module, Reserve Bank is in the process of providing similar features (as in web-based system) in CBS E-Kuber system.

(Chairman: R. Gandhi) [Gandhi Committee] had examined this aspect and had made recommendations to simplify operational procedures for seamless movement of securities from SGL form to demat form and *vice versa* and permit banks and PDs to obtain limited membership of stock exchanges for undertaking proprietary trades in G-sec on the exchanges to promote trading of G-sec on stock exchanges. The Reserve Bank is examining the recommendations in consultation with all the stakeholders. It would be interesting to note that Australia recently passed legislation to enable retail trading of Australian government securities on the Australian Stock Exchange. The Australian government has put a mid-2013 timeframe for trading to commence. All benchmark bonds issued by the Australian government, including Treasury bonds and Treasury indexed bonds will be available for trading. In India, by improving access to order matching platforms and promoting safe clearing and settlement systems, widening access to retail investors is being pursued with vigour.

Factors inhibiting retailing of G-sec in the Indian context

15. Penetration of G-sec to individuals could not be achieved mainly on account of the competition from other instruments, many of them having tax benefits, such as, small savings schemes from the Government like Savings bonds and National Savings Certificates (NSCs). These instruments are targeted at the retail investors and the effective return on these instruments work out to be higher than the yield on marketable securities which have no tax concessions.

16. The predominance of institutional investors and large borrowing needs of the issuer, *i.e.,* 'the sovereign' resulted in market is characterised by very large transaction size. Though we have provided odd lot segment in NDS-OM for trading in small lot size, there

are not many quotes available, thereby discouraging small investors. Thus, the present market for G-sec is not well suited to retail/individual investors who trade in small amounts and are generally buy-and-hold investors. Moreover, G-sec are not actively traded on stock exchanges.

17. Since volatility in prices of fixed-income securities is low *vis-à-vis* equity, investors generally gain through small changes in prices of debt instruments by committing large amounts. While institutional investors, by nature, are big players who transact in large amounts and also have access to funding markets both collateralised and un-collateralised, they are in a better position to transact in this market. Due to a lack of similar facility to individual investors, they are not in a position to trade in these instruments. Thus, speculative interest of retail investors is minimal in G-sec.

18. Normally, retail investors participate in sovereign debt market through mutual funds (MF). G-sec holdings of the mutual funds, however, are also very low and as per latest information available, their holding is around 0.5 per cent of total outstanding G-sec. Of course in the recent times, thanks to huge spurt in market volumes due to transient as well as structural factors providing huge potential for capital gains, G-sec has received greater attraction of the MFs including the gilt funds. One of the reasons for lack of adequate participation of MFs in G-sec is lack of tax concessions on income from debt oriented MFs on lines similar to tax concessions already in place for investment in equity oriented MFs. It may be noted that dividend received by unit holders, dividend distribution tax payable by mutual funds, long-term capital gain are exempted from tax in case of equity oriented mutual funds. Unlike equity oriented MFs, debt MFs are subject to dividend distribution tax at the rate of 12.5 per cent. Besides they are subject to tax on long-term capital gains at 20 per cent of capital gain after allowing indexation benefit or at 10 per cent flat without indexation benefit, whichever is less and short-term capital gains are subject to tax as per the tax bracket applicable to the investor. Such differential taxation acts as a disincentive for mutual funds investments.

19. Lack of investor awareness is another factor impacting retail interest in G-sec market. The market is complex and awareness of the risks and rewards relating to investment opportunities is limited. The terminology like yield curve, yield to maturity, *etc.* may not be easily comprehensible for a common investor. The market participants/intermediaries have not been proactive in providing adequate information/ investor education.

The way forward

20. In India, the need to convert savers into investors is paramount. As described in the draft National Strategy for Financial Education, large participation of domestic retail investors in securities market will reap dividends by increasing depth of securities market, reducing dependence on foreign investors and domestic savers reaping benefits of economic growth. In this regard, all stakeholders including Government, the Reserve Bank and financial institutions must treat promoting retail participation in G-sec market as a priority. I will detail few thoughts on the steps we need to take to revitalise the retail/mid-segment participation.

Improving investor awareness & education

21. Knowledge empowers investors. In case of G-sec market, the investor awareness is low. The national

focus on inclusive growth recognises that financial literacy and education play a crucial role in financial inclusion. Draft National Strategy for Financial Education (NSFE) for India has been prepared under the aegis of FSDC and is in public domain. This document clearly articulates the future vision relating to financial literacy and empowerment leading to inclusive growth. The draft Strategy seeks to create a financially aware and empowered India. There is a need to encourage awareness among retail investor class to promote G-sec as an alternate investment instrument. In pursuit of this objective, stakeholders must make concerted efforts for investor education with regard to G-sec market. Given their reach, media, both print and electronic, have also very important role to play here. Banks, PDs, financial institutions and stock exchanges may take lead in this endeavour by creating awareness about the products, risks and rewards associated with G-sec market. The Reserve Bank has been spreading awareness to mid-segment investors by conducting training sessions/seminars on regular basis.

Launching of new products

22. There is merit in the issuer focusing on products catering to the retail investors. For instance, special bonds called *Obligasi Ritel Indonesia* (ORIs) are issued by the Government of Indonesia, especially for retail investors. These bonds carry higher yields compared to other fixed income options including time deposits and provide monthly coupon payments. These bonds are issued in denomination of Rupiah 5 million and can be purchased by only retail investors in the primary market but they can be traded in the secondary market by both retail as well as institutional investors. In Indian context, one product that could generate significant retail interest is the 'inflation linked bond' for retail investors. The Gandhi Committee has recommended Government of India can consider issuing inflation-indexed bonds (IIBs) specifically for retail/individual investors since inflation affects the poor and middle class significantly. The retail investors generally look for asset class which could provide clean real return, *i.e.*, an instrument which provide complete hedge against inflation. Furthermore, in view of retail investors not having complete information and technical knowhow and thus, lacking expertise in pricing, greater use of non-competitive route could be explored for generating retail demand for IIBs. Towards this end, we are considering increasing the non-competitive portion from five per cent of the notified amount as applicable to the primary auctions of the Central Government dated securities to 10 per cent while launching IIBs. We are in discussion with the Government with regard to issuance of IIBs as part of normal market borrowing program and special bonds linked to inflation could be a medium term target. Similarly mutual funds could design products based on G-sec to capture investor interests. The Reserve Bank provides liquidity support on any day up to 20 per cent of the outstanding stock of government securities, including treasury bills, held by the gilt funds as at the end of the previous working day, to gilt funds to encourage such funds to create a wider investor base for government securities market.

Improving access to the market

23. The existing infrastructure for G-sec *viz.*, depository, intermediaries, trading infrastructure is concentrated in Mumbai. This has led to the concentration of treasury activities of banks and PDs in Mumbai. Catering to retail investors located across the country, requires establishment and maintenance

of a wide distribution network. Banks, by having an existing network of branches spread across the country and on a CBS platform, and Post Offices with a wide geographical presence are well placed to offer investment services to retail investors in the G-sec. This potential must be tapped and leveraged as a distribution channel to cater to retail investors. Banks/ PDs can create designated desks to focus on retail trades.

Leveraging technology for promoting retail trades

24. With new technologies like internet and wireless communication systems, possibilities for cost-efficient sale and distribution of G-sec are increasing. As such, there is an urgent need to leverage upon technology to provide easy and operationally convenient access to the retail investors. New distribution channels can be contemplated. For example, in Singapore bank networks/ATMs are being used to distribute G-sec. In India, some banks have started on-line trading portals for G-sec. One bank has infact vigorously marketing their product which provides wide accessibility to retail investors in G-sec. The bank is also integrating its portal with the mobile banking platform. Other banks/primary dealers may consider similar initiatives for market development.

Improving liquidity in G-sec market

25. Secondary market liquidity in G-sec is limited to a few securities and hence it is difficult to find a market quotes for a large number of G-sec. Due to the lack of secondary market liquidity, investors, especially retail/individual investors end up paying large illiquidity premium when they try selling the illiquid (off-the-run) securities. Lack of liquidity is a critical factor that needs to be addressed for ensuring participation by retail investors in the G-sec market. Gandhi Committee has examined the liquidity problem in G-sec in detail and had made recommendations like consolidation of outstanding G-sec, allocation of specific securities to each PD for market making in them; gradual increase in the investment limit for FIIs in Government securities, prepare a roadmap to gradually bring down the upper-limit on the HTM portfolio in a calibrated manner to make it non-disruptive to the entities and other stakeholders; and promotion of the term-repo market with suitable restrictions on 'leverage' and introduction of tripartite repo in Government Securities. Further, Gandhi Committee also suggested a suitable mechanism for market-making by PDs in the odd-lot segment. The Reserve Bank is in consultation with the stakeholders on the modalities of implementation of these recommendations. There is also merit in the long-term, to establish, a centralised market maker for retail participants in G-sec who would quote two-way prices of G-sec for retail/ individual investors and leverage on existing and possible infrastructure for reaching retail/individual investors.

Reduction in transaction costs

26. Transaction costs for trading and maintaining gilt accounts are high for retail investors. Charges, such as, account-opening fee, which are high and not standardised, need review. A regime of reasonable and uniform charges is customer friendly and can lead to tangible benefits in promoting retail investments since such a move would bring in much needed transparency and induce competition among bank/ PDs, which will be beneficial to the retail investors in the long run. FIMMDA/PDAI may work towards this objective. In order to popularise opening of gilt accounts, the Reserve Bank of India could consider remunerating banks and PDs based on performance of opening gilt accounts in order to incentivise them to

cater to retail customers. Banks/PDs/depositories could also think of some type of basic gilt/demat accounts for limited number of transactions upto certain amount of holdings with reduced charges for the retail investors in debt segment.

Trading in stock exchanges

27. Considering the reach and familiarity of the exchange platforms, promotion of trading in G-sec on the exchanges can be an another means of activating retail interest in G-sec. The Reserve Bank is considering allowing banks and PDs to become members of exchanges to undertake proprietary trades in G-sec. The Reserve Bank is also in consultation with stakeholders to simplify operational procedures for seamless movement of securities from SGL form to de-mat form and vice versa to promote trading of G-sec on stock exchanges. It would be beneficial in this regard if the stock exchanges focus on investor awareness to encourage retail investors.

Incentives for G-sec trading

28. Government may consider providing tax concession on income from debt oriented mutual funds can be a measure aimed towards bringing in new classes of investors as well as encourage further investments in G-sec by existing investors. Providing such concession would incentivise mutual funds and investors to increase participation in the G-sec market. This would also remove the differential tax treatment between debt and equity oriented MFs. Though there is a possibility of loss of revenue, there is high probability that enhanced activity could neutralise the revenue loss.

Summing up

29. Though internationally and in India, G-sec market is predominantly institutional, it is in the interest of both the issuer and investor, that retail participation in G-sec market is encouraged. It would provide a stable source of demand for government securities and this in times of volatility, can cushion the impact of concerted sales by sections of institutional investors. Such demand is essential for financial stability and orderly functioning of the markets. The Reserve Bank has recognised the importance of retail and mid-segment investors many of whom are statutorily required to invest in G-sec and has taken several steps to promote the same. Improving access to both primary and secondary market, providing safe trading and settlement process has made G-sec market more efficient. The working Group (Gandhi Committee) constituted to examine enhancing liquidity in the government securities and interest rate derivatives markets has extensively studied issues pertaining to retail participation and made several useful recommendations. The Reserve bank is evaluating these recommendations in consultation with the market players for their speedy implementation. Certain factors, such as, lack of investor awareness/ education; competing instruments and high transaction costs discourage retail investors from participating in bond market in India. These factors could be addressed by taking steps, such as, improving awareness of investors, introducing new products, such as, the issuance of inflation linked securities would protect retail investor from effects of inflation, thereby preventing loss of purchasing power, improving access through leveraging technology and reducing transaction costs. The Reserve Bank is committed to encourage diversification of the investor base to further deepen and widen the G-sec market. It is also necessary that all other stakeholders like banks, primary dealers as also the media work in earnest to promote retail

participation by actively engaging with the investors and focusing on providing high standard of customer service and hassle-free transaction experience. This has become a very important imperative for our economy given the declining share of household financial savings.

30. I thank ASSOCHAM, in particular, Shri Raj Kumar Dhoot, President, ASSOCHAM and Shri Prithvi Haldea, Chairman, Capital Markets Committee of ASSOCHAM for organising this conference and taking this national mission forward.

Thank you.